Value Matters™

Issue No. 2, 2021

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What Does the Step-Up in Basis Tax Proposal Mean for High Net Worth Individuals and Family Businesses?

Recently, the Biden Administration **announced** elements of its tax agenda in the American Families Plan. The Biden Administration aims to make some significant changes to current tax law.

These changes are highlighted by the following:

- Increasing the top capital gains tax rate to 39.6%
- Increasing the top federal income tax rate to 39.6%
- Increasing the corporate tax rate to 28%

Another substantial proposal includes the elimination of the step-up in basis. The potential elimination of the step-up in basis presents an estate planning opportunity to high-net-worth individuals and family business owners or should at least spur them to contemplate revisiting their estate plans.

What Is the Step-Up In Basis?

The step-up in basis refers to the current tax environment that allows individuals to transfer appreciated assets at death to their heirs at the current market value without heirs having to pay capital gains taxes on the unrealized capital appreciation of those assets that occurred during the individual's life. In other words, heirs currently benefit from a "step-up" in tax basis of inherited assets to the market value on the day of death, and no taxes are paid on unrealized capital appreciation of the assets.

Biden Administration Proposal

The Biden Administration is proposing to eliminate this step-up in basis. This means that the heir would be responsible for the taxes on the unrealized capital appreciation of the assets being transferred as if the assets had been sold. This would result in a large tax burden on the heir especially when considering that the Biden Administration is also aiming to increase the top capital gains tax rate to 39.6%. Specifically, the proposal would end the step-up in basis for capital gains in excess of $1 million (or $2.5 million for couples when combined with existing real estate exemptions). So, the first $1 million of unrealized capital gains would be exempt from taxes and only the excess would be taxed. However, the proposal does state that "the reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business." These protections and exemptions seem to provide some relief for family businesses, but the details of the protections have yet to be specified.

Takeaways

These proposals are certainly not set in stone and may change as the proposals are debated and legislature eventually makes its way through Congress. However, the Biden Administration's current tax proposals could have a significant impact on the estate planning environment.

The potential elimination of the step-up in basis is yet another reason for high-net-worth individuals and family business owners to make estate plans or revisit their current estate planning techniques. When considered alongside other Biden Administration proposals such as an increase in the capital gains tax and the fact that the increased lifetime gift and estate tax exclusion limits are set to sunset in 2025, now is a great time to have a conversation about planning. Contact a professional at Mercer Capital to discuss your specific situation in confidence.

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Capital Gains Taxes and Family Businesses

Don't Let the Tax Tail Wag the Family Business Dog

Excerpted from Mercer Capital's *Family Business Director Blog*

"The perfection of taxation consists in so plucking the goose as to procure the greatest amount of feathers with the least possible amount of squawking." So said Jean-Baptiste Colbert, King Louis XIV's finance minister in regard to 17th century tax policy.

As it stands, your family goose may be subjected to some additional plucking soon. The Biden administration is planning to **nearly double the federal capital gains tax rate** on taxpayers earning more than $1 million from 20% to 39.6%. In states with high taxes, the combined blended rate could top 50%.

Are you and your directors about to start squawking? Or are you already hoarse? While we steer clear of politics here at ***Family Business Director***, we do aim to inform business owners on the three key financial decisions family businesses face: **dividend policy, capital structure, and capital allocation.** Clearly a move of this magnitude could leave certain planning strategies less advantageous and could possibly affect key financial decisions. Below we briefly touch on the capital gains tax and provide some helpful reminders for family business owners.

What Is the Capital Gains Tax?

From the **Tax Policy Center**, a capital gain is realized when a capital asset is sold or exchanged at a price higher than its basis. Capital gains and losses are classified as long term if the asset was held for more than one year, and short term if held for a year or less. Under current law, short-term capital gains are taxed as ordinary income at rates up to 37%; long-term gains are taxed at lower rates, up to 20%. Taxpayers with modified adjusted gross income above certain amounts are subject to an additional tax of 3.8% on long- and short-term capital gains stemming from the Affordable Care Act.

Family shareholders face the prospect of capital gains taxes upon the sale of the business or other significant assets. This could be commercial property, stock holdings, or a business interest that has appreciated over time.

Don't Panic

From a cursory reading of the financial press and the short-lived market dip, public equity markets appear to be buying gridlock and selling tax hikes. ***Barron's* writers, Goldman Sachs analysts**, and **financial twitter prognosticators** all seem to point to either a more modest change (increase to

28%-30% rather than 39.6%) or some watered-down version of the proposal. We note that, earlier this year, **eight Senators who caucus with the Democrats voted against a $15 minimum wage**, giving further pause to the idea that 50 plus is enough to ram anything through both chambers of congress. Family businesses would be mindful not to count their tax chickens before they hatch – or are even laid.

Do Take a Second Look

While we don't want to talk out of both sides of our mouth, taking a look at some appreciated assets, especially if they are readily liquid, could take some tax risk off the table. Many of the family businesses we work with have considerable stock portfolios outside their main operating businesses. Consider having a second conversation with your financial advisor to see if you could take advantage in some large winners in the current environment. And for future planning, check with your advisors to see if you can spread events that trigger capital gains over multiple periods to avoid the $1 million income level. Like-kind exchanges and other tax-planning strategies may be worth a second read if the preferential tax treatment goes away.

Remember the Big Picture

As we have written about continuously in the blog, family business directors have longer-term objectives than meeting next quarter's numbers. Family business directors plan with long-term family wealth and succession in mind. As we noted in dissecting the world's largest family businesses, **almost half of the 750 companies in the list have been in business for over 70 years.** Over that same time, the capital gains rates have changed dozens of times, **oscillating between high teens to just under 40%** (albeit briefly in the mid-to-late 70s). **What your family business means to you,** whether it's a growth engine or a source of lifestyle, likely won't change dramatically as a result of your capital gains tax exposure. Remember, running your business and fostering long-term wealth creation is the ultimate goal of any family business director.

Conclusion

When thinking about your current business situation, the toughest time horizon to have is short term. Should we accelerate plans to sell so we can avoid a larger tax bill? Should we realize some gains in the family securities portfolio to avoid the possibility of an increase in long-term capital gains rates? We think long-term minded family business directors are in prime position to ride through the tax waves and steer their family ships safely on their long voyages. Give one of our family business professionals a call today to talk about balancing tax concerns with the long view on your family business.

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Quantifying Expected Holding Period Premiums from Restricted Stock Transactions

Excerpted from Chris Mercer's Blog

This is the third in a series of articles about restricted stock discounts. In the **first article**, we examined the Silber Study, which should have told all appraisers that the use of averages of restricted stock studies to estimate marketability discounts for illiquid minority interests of private companies. The **second article** proved that the only explanation for the difference in restricted share prices and publicly traded prices of issuing companies is something we called the expected holding period premium or HPP.

This third article examines a hypothetical restricted stock transaction from the earlier two year holding period requirement under SEC Rule 144 (prior to the change to a one year holding period in 1997).

We examine a hypothetical transaction.

- The freely traded price is $10.00 per share
- The restricted stock transaction price is $7.50 per share
- The issuing company pays no dividends and reinvests earnings to finance future growth
- The restricted stock discount is 25%
- The restricted stock minimum holding period is two years
- There are additional restrictions under the "dribble-out" rules for large blocks, and this is a large block

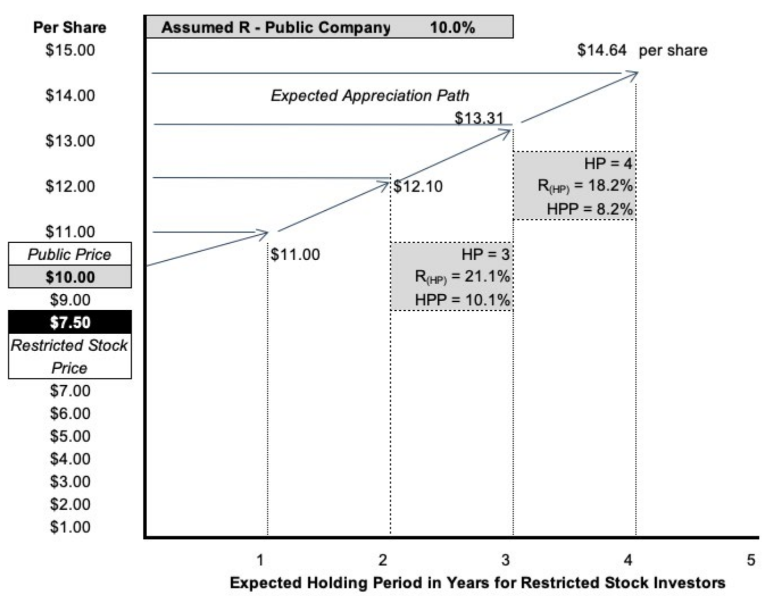

Exhibit 8.13
Reconciliation of Restricted Stock Transaction Price with Public Market Price

We show the restricted stock discount in Exhibit 8.13 from the third edition of *Business Valuation: An Integrated Theory*, which is available on **Amazon.com** and from other booksellers. Look first at the vertical axis, which shows the two prices noted on the previous page.

To address the 25% restricted stock discount, we must look at expectations regarding the public company and for the restricted stock purchasers on the transaction date. In the second article, we showed that the discount is caused by additional risk to the restricted shares relative to freely traded shares. In this article, we unpack that observation.

Assume in Exhibit 8.13 that the required return for the issuing public company is 10%. The expected growth in value, given no dividends, is 10% per year. So the expectations embedded in the public stock pricing is for growth in value of 10% per year – to $11.00 per share in year one, and to $12.10 per share by the end of year two.

Given the size of the block at issue and the trading volume in the public company's shares, the dribble-out rules will require somewhere between an additional year or two for the investor to obtain full liquidity. The expected growth in value to three years is $13.31 per share and to four years is $14.64 per share.

The expected return for public shareholders is therefore 10% per year over this period based on the transaction date price of $10.00 per share. What about for the restricted share purchasers who purchased their shares for $7.50 per share?

The question for analysis is this: what is the incremental return, or HPP, or expected holding period premium to the 10% discount rate for the public company, that can be inferred by the restricted stock transaction? The answer requires our assumption regarding the expected holding period, which is effectively three to four years. Given the information thus far, we can calculate expected holding period premiums to three and four year expected holding periods. We do so in Exhibit 8.14.

In the exhibit, we calculate the expected future price per share after three and four year holding periods showing the expected future share prices noted just above ($13.31 per share and $14.64 per share, respectively). We have expected future values. The present value from the perspective of restricted share purchasers is $7.50 per share. Given present values for three and four expected holding periods and future values, we can calculate the implied required returns to justify the discounted $7.50 per share transaction price.

The implied R_{hps} (or expected returns over the holding periods) are 21.1% (three year holding periods) and 18.2% (four year expected holding period). Given the discount rate for the public company of 10%, the implied holding period premiums are 11.1% (three years) and 8.2% (four years).

	Public Price	
Beginning Value	**$10.00**	**Per Share**
Holding Period	**3 Years**	**4 Years**
Expected Future Value	$(1 + R\%)^{\wedge 3}$	$(1 + R\%)^{\wedge 4}$
Future Price Per Share	$13.31	$14.64
Present Value Per Share	$7.50	$7.50
	(Transaction Price Per Share)	
Implied Restricted Stock Discount	*25.0%*	*25.0%*
R_{hp} (Investor Req'd Returns)	21.1%	18.2%
less: R for PubliCo	10.0%	10.0%
HPP (Holding Period Premium)	**11.1%**	**8.2%**

Exhibit 8.14
Calculation of Required Returns and Expected HPP

Astute readers may note that I selected an implied discount rate of 10% for the public company, and that might impact the result. Based on our analysis, the range of implied holding period premiums is only modestly impacted by changes, even significant changes, in the assumed underlying public company discount rate.

If you have read this series and you are using averages of restricted stock studies as a primary basis for estimating marketability discounts (or DLOMs) for illiquid minority interests of private companies, I hope your discomfort level is rising. In the **fourth article**, we examined some basic and summary information from existing restricted stock studies. Your comfort level will not be helped by this analysis.

This discussion of restricted discounts is based on Chapter 8 of the third edition of *Business Valuation: An Integrated Theory* (by Travis Harms and me). The book is published by John Wiley & Sons, Inc. You should order personal copies for all of your professionals. **Kindle and other electronic versions** are available as well. The book is approximately 300 pages in length and in a smaller than textbook size. It will not, as many valuation texts, overwhelm you with its length. But it will inform you about valuation theory better than any book on the market.

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Read the Rest of the Series

In this series we examine the use (or misuse) of restricted stock discounts directly to attempt to develop marketability discounts for illiquid minority interests of private companies.

 # 1 - The Silber Study of Restricted Stock Discounts – 1991

 # 2 - Restricted Stock Discounts: The Expected Holding Period Premium is the Cause

 # 3 - Quantifying Expected Holding Period Premiums from Restricted Stock Transactions

 # 4 - The Myth of the 25% – 45% "Typical" Range of Restricted Stock Discounts Must Die

 # 5 - Addressing Comments Regarding Restricted Stock Discounts

Estate of Michael J. Jackson v. Commissioner | Key Takeaways

It is imperative for estate planners to engage valuation analysts that perform the proper procedures and follow best practices when performing valuations for gift and estate planning purposes. It is necessary to have a well-supported valuation because these reports are scrutinized by the IRS and may end up going to court. The recent decision by the U.S. Tax Court in Estate of Michael J. Jackson v. Commissioner provides several lessons and reminders for valuation analysts, and those that engage valuation analysts, to keep in mind when performing valuations for gift and estate planning purposes.

Michael Jackson, the "King of Pop," passed away on June 25, 2009. His Estate (the "Estate") filed its 2009 Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, listing the value of Jackson's assets. After auditing the Estate's tax return, the Commissioner of the Internal Revenue Service (the "Commissioner") issued a notice of deficiency that concluded that the Estate had underpaid Jackson's estate tax by a little more than $500 million. Because the valuation of some assets were considered to be so far off, the Commissioner also levied penalties totaling nearly $200 million on the Estate. The IRS and the Estate settled the values of several assets outside of court. The case involved three contested assets of Michael Jackson's estate:

1. Jackson's Image and Likeness
2. Jackson's interest in New Horizon Trust II ("NHT II") which held Jackson's interest in Sony/ATV Music Publishing, LLC, a music-publishing company
3. Jackson's interest in New Horizon Trust III ("NHT III") which contained Majic Music, a music-publishing catalog

We discuss the key topics that the Tax Court ruled on and addressed that inform valuation analysts in the preparation of quality valuation reports.

Known or Knowable

It is important that valuation analysts only rely on information that was known or knowable at the valuation date.

In the decision, the Tax Court rejects the analysis of experts on several occasions for using information that was "unforeseeable *at the time of Jackson's death.*" The Tax Court goes on to state that "foreseeability can't be subject to hindsight."

It can be difficult to distinguish and depend on only the information known or knowable at the valuation date especially when a significant amount of time has passed between the current date and the valuation date. Therefore, a careful examination of all sources of information is necessary to be sure that it can be relied upon in the analysis.

As can be seen from the Tax Court's opinion, valuation analysts and experts can undermine their credibility by relying on information that was not known or knowable at the valuation date.

Tax Affecting S Corporations

The Tax Court, in this specific case, did not accept the tax affecting of S Corporations: "The Estate's own experts used inconsistent tax rates. They failed to explain persuasively the assumption that a C corporation would be the buyer of the assets at issue. They failed to persuasively explain why many of the new pass-through entities that have arisen recently wouldn't be suitable purchasers. And they were met with expert testimony from the Commissioner's side that was, at least on this very particular point, persuasive in light of our precedent. This all leads us to find that tax affecting is inappropriate on the specific facts of this case." The Tax Court did, however, leave room for the possibility of tax affecting being appropriate by stating, "we do not hold that tax affecting is never called for."

At Mercer Capital, we tax affect the earnings of S corporations and other pass-through entities. Given that this issue continues to be a point of contention, it is imperative that valuation analysts provide a thorough analysis and clear explanation for why tax affecting is appropriate for S corporations and other tax pass-through entities.

Developing Projected Cash Flows

In the valuation of NHT II, the Court found it more reasonable to use the projections of Sony/ATV in the development of a forecast used in the income approach rather than relying on historical financial performance to inform the projection. The Tax Court based its decision on the fact that "the music-publishing industry was (and has remained) in a state of considerable uncertainty created by a long series of seismic technological changes. We think that projections of future cashflow, if made by businessmen with an incentive to get it right, are more likely to reflect reasonable estimates of the short-to-medium-term effects of these wild changes in the industry that even experts, much less judges, are unlikely to intuit correctly."

This decision makes it clear that valuation analysts need to fully understand the industry in which the company operates and develop a forecast that is most reasonable given the information available as of the valuation date.

In cases where analysts have access to a projection developed by management, valuation analysts should have a clear, well-reasoned rationale for not relying on the forecast should they decide not to use it in the analysis. However, valuation analysts should not blindly accept management's forecasts as truth but should perform proper due diligence to assess the reasonability of the forecast and clearly articulate any deviations from management's forecast.

Other Topics Addressed

A few other topics of note are addressed throughout the decision that can help valuation analysts provide reliable valuation analyses.

On more than one occasion, the Tax Court sided with the expert that provided a compelling explanation for the use of a certain assumption rather than arbitrarily using an assumption without explanation. The Tax Court also sided with one expert simply because they provided a clear citation for their source when another expert did not. The Tax Court also called out the inconsistency of an expert in their report and testimony. These topics addressed by the Tax Court demonstrate that consistently explaining and citing the sources of assumptions and key elements of the valuation analysis help to produce a supportable valuation analysis.

Finally, the expert for the Commissioner seriously damaged their credibility in the eyes of the Tax Court when the expert was caught in a couple lies during the trial. The Tax Court found that the expert "did undermine his own credibility in being so parsimonious with the truth about these things he didn't even benefit from being untruthful about, as well as not answering questions directly throughout his testimony. This affects our fact finding throughout."

Takeaways & Conclusion

The table below presents the valuation conclusions of the Estate, Commissioner, and the Tax Court at trial. This decision has shown that it is critical for valuation analysts to present quality valuation reports that are clear, supported, and follow accepted best practices.

At Mercer Capital, estate planners can be confident that we follow the proper procedures, standards, and best practices when performing our valuations for gift and estate planning. Mercer Capital has substantial experience providing valuations for gift and estate planning as well as expert witness testimony in support of our reports. Please do not hesitate to contact one of our professionals to discuss how Mercer Capital may be able to help your estate planning needs.

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Valuations of the Three Disputed Assets

Asset	Estate	Commissioner	Tax Court
Jackson's Image & Likeness	$3,078,000	$161,307,045	$4,153,912
NHT II	$0	$206,295,934	$0
NHT III	$2,267,316	$114,263,615	$107,313,516

Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

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